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Supplement to ED/2009/12 *Financial Instruments: Impairment*

MAJOR POINTS

Our overall view on the proposals

1. ICAEW welcomes the opportunity to comment on EFRAG's draft comment letter, published in February 2011, on the International Accounting Standards Board's Supplement to ED/2009/12 *Financial Instruments: Impairment*. Our responses to the main issues highlighted by EFRAG are set out below. A draft of our response to the IASB, which has not yet been finalised, is attached to this letter.

2. Overall, we feel that the new proposals could be more operational than the original exposure draft, although there has been insufficient time for detailed analysis. The proposals address some of the issues we raised on the original exposure draft but there are many outstanding areas, such as measurement. Therefore it is difficult to be definitive.

3. Although we support flexibility being included in the final standard to ensure the adequacy of the impairment allowance, we have concerns with the 'minimum impairment allowance amount' as set out in the proposals. Nevertheless, we can accept the introduction of a 'floor' with a set 'foreseeable future' of one year if this compromise is necessary to achieve convergence, as long as the final outcome was a high quality, operational standard with clear underlying principles.

Our thoughts on EFRAG's high level comments

4. While we accepted that the approach included in the IASB's original exposure draft had some conceptual merits, we felt that its application was so complex that the resulting output would be difficult to understand and explain. Therefore, unlike EFRAG, we did not support the use of the expected cash flow model and are therefore not concerned about whether the proposed model is an acceptable simplification or not. We would judge this model on its own merits and believe a single model that can be applied to all financial assets carried at amortised cost should be the goal.

5. Making the original proposals operational was our biggest concern and by including a number of our suggestions in their supplementary proposals we believe that the IASB has made progress, although there are many outstanding areas before it can be certain that the goal has been achieved. We encourage the IASB to make sure that there is sufficient time to develop a single impairment model and that it is subject to due process, including further field testing.

RESPONSES TO SPECIFIC QUESTIONS RAISED BY EFRAG

EFRAG question 1
Do constituents believe that a consistent impairment approach for the determination of impairment allowances for financial assets carried at amortised cost is preferable to multiple approaches? Why or why not?

6. We are supportive of a single impairment methodology that can be applied to all financial assets carried at amortised cost.

EFRAG question 2
Do constituents believe that the proposals are at least as operational for financial assets carried at amortised cost other than those managed within open portfolios (e.g. assets managed in closed portfolios and individual assets)? Why or why not?

7. We do not see why the proposals should be less operational for closed portfolios, provided that the time-proportional expected losses are reappraised each period so that any unused allowance is removed from the balance sheet by the end of the life of the portfolio. This aspect may need to be better explained if the proposals were to be applied to individual assets and closed portfolios.

8. Whether the proposals are at least as operational for individual assets may depend on the measurement requirements, particularly whether it is possible to determine initial expected losses for individual assets. If the intention is that there is no initial expected loss so that impairment is only recognised when there is an expectation of loss, then it may be that the proposals are operational to individual assets. Since individual assets have credit spreads, it is more likely that entities would be required to determine loss expectations on individual assets, which may be problematic for some entities and some types of asset. Whether the proposals are operational depends on whether the expected losses are determined based on best estimate or on probability-weighted outcomes. We have concerns that, outside areas like insurance companies, probability-weighting is not well understood or applied, even by large banks. Applying probability-weighting to individual instruments will be even more problematic than applying it to large portfolios with historic loss experience.

EFRAG question 3
Do constituents believe that the proposals are operational for portfolios other than loan portfolios (e.g. bond portfolios?)

9. We have some concerns about whether the proposals are operational for portfolios other than loan portfolios. It is difficult to grasp what is meant by an entity's risk management objective changing from one of receiving regular payments to one of recovery for portfolios of bonds. The examples in paragraph B3 certainly do not make sense in the context of such portfolios and those in paragraph B4 may not help or do not guarantee an outcome that makes sense intuitively.

10. Imagine a portfolio consisting of government bonds issued by countries such as Greece, Ireland and Portugal. Everyone would accept that there is an increased credit risk on this portfolio. However, it appears to us that under the guidance in paragraphs B3 and B4 it is likely that these assets would remain in the 'good book' unless there had already been a default. This appears contrary to what most people would expect.

EFRAG question 4
Do constituents believe that requiring a time-proportionate approach that allows loan loss profiling can deal with the issue of an early loss emergence scenario?

11. A time-proportionate approach that allows loan loss profiling is one alternative approach to dealing with the issue of an early loss emergence scenario, but we believe it would be less

operational that the proposed 'floor'. However, we do support some flexibilty to allow entities to recognise losses not captured in the 'bad book' or in the time-proportional losses in the 'good book' where they have probable cause to believe losses will occur in the future.

EFRAG question 5
Do constituents believe the proposed approach is operational? If not, would you recommend a different approach?

12. While we believe that the proposed approach will be challenging, we believe that it is more capable of being applied in in practice than the original exposure draft. We have particular concerns about whether the current proposals are operational for smaller banks which apply the Basel standardised approach and for other entities, although we recognise that such entities may have many fewer portfolios and a less complex business model.

EFRAG question 6
Would the proposed approach for determining the impairment allowance be operational outside the financial services industry?

13. We have concerns about whether the current proposals are operational for entities outside of the financial services industry where there is less emphasis placed on credit risk management. To some extent this will depend on the measurement requirements which are not included in the supplementary document.

EFRAG question 7
Would the proposed approach provide decision useful information? If not, how would you modify the proposals?

14. We believe that the proposed approach could potentially provide information that is useful for decision-making. However, due to the level of judgement inherent within the proposals there will inevitably be a degree of inconsistency on application. Therefore, in order to maximise the usefulness of the information provided and to increase comparability, we believe that adequate disclosures are necessary.

EFRAG question 8
Are the definitions of 'good book' and 'bad book' consistent with the existing practice for credit risk management? Why or why not?

15. We believe that the definitions of 'good book' and a 'bad book' are consistent with credit risk management. However, we note that the reliance on risk management is likely to result in inconsistencies between different entities and even between different types of portfolio and portfolios in different jurisdictions in the same entity where risk management and local law and custom differ. We also note that paragraph B3 is not consistent with paragraph B4

EFRAG question 9
Are these definitions an appropriate driver for the application of the two different approaches to the recognition of expected credit losses? Why or why not? How would you suggest to amend these definitions?

16. The current proposals state that assets should be transferred to the 'bad book' when the entity's risk management objective becomes one of recovery rather than one of receiving regular payments. The application of paragraph B3 may result in a 'bad book' much further down the credit process than would be expected. We are concerned that this would not be widely understood and that any differences in measurement between portfolios in the 'bad book' and those that are close to being put in the 'bad book' make sense. In our view, some type of 'floor' may be helpful to act as a bridge between the 'good book' and 'bad book'.

17. An alternative approach would be to build on the indicators of impairment in IAS 39. We do not support this approach, which would not address some of the concerns raised with IAS 39 and would not be in keeping with the risk management approach. Building on the risk management approach should be more cost effective and therefore more operational.

EFRAG question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated according to paragraph 2.1(a)(i)? For which particular types of portfolios do you expect it to be lower?

18. We have heard a number of commentators suggest that the ‘floor’ will typically be equal to or higher than the amount calculated using the time-proportional method for some or all types of portfolio. This will be more likely to be the case for short duration portfolios, such as those with an average life of less than four years. Since we expect that, on average, the time-proportional loss allowance will be about 50% of the lifetime expected losses for an open portfolio, this does not seem an unreasonable assumption. However, we have seen no empirical evidence that supports or refutes this view. We encourage the IASB to undertake additional field testing to provide a better basis for deciding how best to proceed in this area. If the ‘floor’ is to be included to achieve a converged approach, we suggest that the ‘foreseeable future’ is limited to one year to ensure that, overall, the proposals operate as intended.

EFRAG question 11

Are constituents aware of specific instances where it would be impracticable to discount expected credit losses even if it were calculated on a simplified basis? If so, please provide examples of such situations in addition to the explanation of why it would be impracticable.

19. We are not aware of any specific instances where this would be the case.

EFRAG question 12

Are constituents aware of instances where it would be impracticable to determine the effective interest rate, or an approximation thereof, for particular portfolios of financial assets carried at amortised cost? If so, please provide examples of such situations in addition to the explanation of why it would be impracticable.

20. We are not aware of any specific instances where this would be the case.

EFRAG question 13

The G-20 Finance Ministers and Central Bank Governors called for convergence towards a single set of high-quality, global, independent accounting standards on loan-loss provisioning and the impairment and valuation of financial assets. They encouraged the IASB to take account of the Basel Committee guiding principles on IAS 39 and the report of the Financial Crisis Advisory Group.

To understand the possible broader impacts of the proposals in the Supplementary Document, EFRAG would like constituents to comment on whether or not they believe the proposals:

- **(a) result in useful information to users in general;**
- **(b) promote a level playing field;**
- **(c) are pro-cyclical;**
- **(d) give rise to regulatory issues or concerns; or**
- **(e) have other macroeconomic effects.**

21. We believe that proposals produce useful information to users in general. However, as noted in our reply to EFRAG question 7 above, in order to maximise the usefulness of the information provided and to increase comparability, we believe that adequate disclosures are necessary. We have some concerns that the time-proportional loss charged in a particular period and the

allowance recorded in the balance sheet (which we think will generally represent say 50% of lifetime expected losses) will have limited information content and may not be easily understood by users of the financial statements. Explaining the assumptions underlying the expected loss figures is probably of more use than the proposed detailed movement over time analysis of allowance accounts.

22. The proposed model requires the application of significantly more judgement than is required by IAS 39. We therefore regard appropriate disclosures as being essential if users are to understand the effects of credit risk on an entity's financial position and performance. In particular we believe that such disclosures should provide sufficient information to enable users of the financial statements to assess the judgements made by management and to enable them to draw meaningful comparisons across entities. In practice, we have concerns about whether this can be achieved, given the volume of assets of different types in different jurisdictions. Resolving the issue of how this volume of data can be aggregated into meaningful and understandable information is critical.

23. We believe that the proposals are generally pro-cyclical. However, we note that the 'foreseeable future' is a dynamic rather than static concept and will change depending on circumstances. Entities may have a shorter view of the 'foreseeable future' in times of high volatility and therefore potentially lower credit losses than in more stable times. It may be that this would not necessarily result in lower losses being recognised in times of volatility because there may well be higher expected losses even over a shorter time horizon.

24. We are not aware of any regulatory issues that these proposals would give rise to. We expect regulators to consider the implications of any accounting changes when using financial statements for their own purposes.

25. We are not aware of any macroeconomic effects of these proposals.

EFRAG question 14

Do constituents believe that it would be operational to apply the proposed impairment requirements to all loan commitments that are not accounted for at fair value through profit as well as financial guarantee contracts? Why or why not?

26. We believe that the proposed requirements could be operational if applied to loan commitments and financial guarantee contracts. However, the current proposals give no guidance on how the impairment model should be applied in such instances.

27. Creating an impairment allowance prior to a loan being drawn down creates some additional presentational issues since the allowance represents a liability (for an onerous contract) rather than a reduction to the value of an asset. It should be presented separately to avoid distorting coverage ratios. In some cases when facilities are set up the lender will receive fees in advance that are deferred and recognised as part of the effective interest rate calculation as and when the loan is drawn down. In these situations, the impairment charge will not match the recognition of interest income which appears to be the consequence of the allowance representing a liability.

EFRAG question 15

Do constituents believe that the proposed disclosure requirements are appropriate?

28. The proposed model requires the application of significantly more judgement than is required by IAS 39. We therefore regard appropriate disclosures as being essential if users are to understand the effects of credit risk on an entity's financial position and performance. In particular we believe that such disclosures should provide sufficient information to enable users of the financial statements to assess the judgements made by management and to enable them to draw meaningful comparisons across entities. In practice, we have concerns about whether this can be achieved, given the volume of assets of different types in different

jurisdictions. Resolving the issue of how this volume of data can be aggregated into meaningful and understandable information is critical.

29. On the whole we are supportive in principle of the proposed disclosure requirements which we believe would increase transparency and comparability. However, we do have some reservations as explained in our draft response to the IASB.

Please contact me should you wish to discuss any of the points raised in this letter or the attached draft response.

Yours sincerely

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